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ROUBLE CONVERTIBILITY: A REALISTIC TARGET?

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ROUBLE CONVERTIBILITY: A REALISTIC TARGET ? [1]

by

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1. INTRODUCTION.

The aim of this essay is to discuss a feasible process of transition to external convertibility for the Soviet rouble. In recent Soviet economic literature there has been a lively debate on this issue, and the Soviet leadership has also given it serious attention [2]. However, many of the points discussed still remain rather confused and the long-term strategy of the Soviet leadership has, as yet, not been disclosed.

This paper is based on some assumptions, which, due to the narrow limits of the paper itself, will only be outlined briefly here. First, it is assumed that a positive correlation exists between central planning, bilateralism and inconvertibility: the convertibility issue arises when a planned economy moves from a strictly controlled system of planning and management to a more decentralized one. Second, a necessary condition for the introduction of meaningful convertibility is the positive development

1. Paper prepared for the 1989 NATO Economics Colloquium "Soviet economic reforms: implementation under way" Brussels, March 15th-17th, 1989. Financial support from the EUI for a research visit to the Soviet Union in January 1989 is gratefully acknowledged. In writing the paper I have benefitted enormously from daily discussions and previous work on similar topics with Efisio Espa, as well as suggestions and useful comments by Alberto Chilosi, Sheila Marnie, Mario Nuti and Fabio Sdogati. However, they should not be held responsible for mistakes or lack of clarity.

2. To the best of my knowledge, the possibility of introducing convertibility was first officially mentioned at the June 1987 Meeting of the Central Committee, where it was presented as a long-term objective. Subsequently, Prime Minister N. Ryzhkov at the forty-third session of the CMEA spoke about Soviet support to "the accord of the majority of countries on the introduction of the mutual convertibility of national currencies and the transferable rouble for servicing direct production links, joint economic activity and scientific technological co-operation". BBC Summary of World Broadcast EE/8699, 15.10.1987.

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of economic reforms, both of the domestic economy and the external sector. Finally, currency liberalization goes hand in hand with trade liberalization. The process, however, must not happen too quickly: opening up must be gradual and long-term.

The paper is organized as follows:

The characteristics of three different systems of planning and management (the centrally planned economy, the modified planned economy and the reformed planned economy) are briefly outlined. The recent developments of the reform process in the USSR and its likely development are judged against this analytical framework. There is a brief discussion of the convertibility concept, after which a feasible path of transition to convertibility for the Soviet economy is outlined. Two scenarios are sketched: the first examines the transition process to regional convertibility; the second tries to figure out a possible way of reaching a worldwide form. Finally, the possibility of bringing about external convertibility of the Soviet rouble is assessed: preconditions and obstacles, as well as the pros and cons of regional versus worldwide convertibility are considered. Brief concluding remarks summarise the main findings of the paper.

1. REFORMS, PLANNING AND CONVERTIBILITY.

In a recent article in *Economic Policy*, D. M. Nuti introduces a taxonomy of the reform process which distinguishes between a centrally planned economy (CPE), a modified planned economy (MPE) and a reformed planned economy (RPE). This will be adopted for our analysis [3]. In fact, the Soviet economy presented, up to the first half of the 1980s, all the features of a classic centrally planned economy (also defined by Berliner as a "documonetary" economy). The process of reform initiated thereafter has modified many of these characteristics, although an important part of the system of planning and management remains unchanged.

a. Foreign trade and convertibility in the "documonetary" economy.

In the economic literature, CPEs in general, and the Soviet Union in particular, have been treated mainly as closed, semi-autarkic economies. The characteristics of the centralized system of planning seem to indicate, in fact, a substantial lack of openness in the sense of direct and automatic exposure to trade competition. In the particular environment of a classic CPE, where all the relations between variables have to be defined in advance, trade introduces uncertainty into the planning process and makes the domestic economy subject to external fluctuations. According to standard theory [4] the level of trade of a CPE is mainly determined by import requirements: exports are considered a "necessary evil" to procure imports. In other words the quantity-oriented nature of the centralized system tends to limit risks by minimizing dependence on

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3. Cf. Nuti (1988).

4. Cf. Brown (1968); Holzman (1974); Wiles (1968).

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outside suppliers, even for products that could be acquired more economically abroad. It has further been suggested that the centralized system tends to prevent full exploitation of the comparative advantages and participation in the international division of labour. There is a trade-off between minimizing the risks involved in trade and complete exploitation of the advantages deriving from participation in international trade.

On the financial side, the main characteristic of the Soviet economy is the well known external inconvertibility of the rouble [5], its role as purely domestic currency. A domestic capital market is absent and the Soviet authorities do not intervene to support an official parity in the foreign exchange market. The only function exercised by the exchange rate is that of converting prices in foreign currencies into domestic prices for Balance of Payments purposes.

The main consequence of inconvertibility is the large amount of trade that takes place on the basis of bilateral agreements. This does not involve money settlement and prices tend to be specially negotiated. In bilateral trade with other centrally planned economies prices used are supposed to reflect world prices, while intra-CMEA trade prices are now adjusted annually on the basis of "world" averages from the preceding five years.

Four features of the financial system regulating foreign trade are worth stressing.

First, the rouble does not link domestic to world prices and the structure of domestic prices can and does diverge sharply from that of foreign trade prices. The Foreign Trade Organization pays the Soviet suppliers and charges Soviet purchasers appropriate wholesale prices, in such a way that the domestic operator never has foreign currency at his disposal. With the use of a price equalization mechanism, the wide disparity between domestic and *valuta* prices is adjusted via the state budget. Broadly speaking, from the microeconomic point of view, there are no price differences for firms whether they sell abroad or on the domestic market [6].

Second, there is no uniform criterion for determining the efficiency of foreign trade. Owing to the fact that the prices used do not reflect the desirability of a given transaction, the methodology for calculating the effectiveness of foreign trade is, as often happens in Soviet practice, based entirely on "engineering" rules, rather than on an evaluation of costs and benefits. Very briefly, the methodology for calculating the economic effectiveness of foreign trade is based, for exports, on a comparison of *valuta* earnings with costs in roubles, adjusted with a corrective coefficient to compensate for the inadequacy of internal prices. Imports are compared with analogous goods or with the cost of goods exported to pay imports (although it is almost impossible to identify which goods are exported). On the one hand this procedure has allowed domestic prices

5. The rouble was removed from international quotations in 1926.

6. In reality a system of incentive markups (nadbavki) on the wholesale prices operates with controversial results. A decree of 1985 - Postanovlenie n. 699, 12/7/1985 - established a surcharge of up to 20% of the wholesale price for deliveries of machinery and equipment exports to the convertible currency area. Ekonomicheskaya Gazeta, 32, August 1985.

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to be insulated from variations taking place on the external market, but on the other hand it is the cause of important time lags in the transmission of world market signals.

Third, the system offers few incentives to boost exports and to rationalize imports. With regard to domestic sources of supply, the central authorities face strong pressure from below (i.e. branch, Ministries, enterprises) for additional imports, especially for producer goods. This is in part the outcome of problems which often characterize a CPE, such as the positive correlation of incentives with volume and/or gross value of output and the lack of penalties correlated with the costs of production, which leads to an "unlimited" demand for resources, or to preference being given to investment as opposed to innovation. At the same time imports depend not only on the presence of a shortage, but also on the degree of priority given to the shortage product. Planners also face export constraints from below, in so far as special bonuses for exports are not sufficient to make production for the foreign market attractive. In particular costs connected with the improvement of quality, delivery and servicing of exports are higher than the gains assured by the incentive system.

Fourth, in many respects the rouble is not fully convertible into goods even within the USSR. Money alone is not sufficient, outside the retail sector, and in some cases even within it, to provide a claim on available goods; a document (plan allocation) is also needed.

b. The role of the external sector in the MPE.

The Soviet economy can no longer be described as rigidly centrally planned, since a more decentralized system is being built up. Schematically, the new system is characterized by a substantial improvement in planning and management, with increased individual responsibility for the results obtained, greater enterprise autonomy, and encouragement of various forms of private enterprise. A large part of production is however still subject to direct control, through state orders (*Goszakazy*); prices in the consumer markets are fixed administratively, and resources are only partially allocated through the market.

The reorganization of the foreign trade sector has granted some enterprises the right to operate directly on the foreign market, i.e. without the mediation of the Ministry of Foreign Trade and Foreign Trade Organizations [7]. Many Soviet economists maintain that the final aim of the reform is a dramatic transformation of the nature of foreign trade operations: the complete abolition of trade and currency monopoly and the introduction of trade in foreign currency based on a unified and realistic exchange rate.

Since January 1987, twenty Ministries and about seventy associations and enterprises have been able to import and export without the preliminary authorization by the Ministry of Foreign Trade (now the Ministry for Foreign Economic Relations). Subsequently, the right has been extended to a larger number of economic organizations (about 150 at the end of 1988) and, from April 1989, it will apply to all economic units

[7]. For a more detailed description of the Soviet reform process in the foreign trade sector see Daviddi (1989).

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"whose output is competitive on the foreign market" [8]. The enterprises which cannot enter directly the external market, can utilize specialized foreign trade organizations, which, however, will no longer be a branch of the Ministry, but specialized firms carrying out these operations with the necessary expertise.

These enterprises are also authorized to retain and use part of the hard currency they earn, which is deposited in a special fund. However, the way in which the fund is managed by the *Vneshnekonbank* (the bank for foreign economic relations) has given rise to criticism. In fact, it has so far remained in a special account at the *Vneshnekonbank* during the fiscal year; the bank authorized the use of funds collected by the enterprises in 1987 only from April 1988, even though the recent Decree called for an immediate allocation of the funds [9]. Major criticism is also directed at the great variability of the retention percentage applied (from 2% to 80% of currency earned according to products), and the lack of possibility to transfer funds between enterprises. As a result only half of the funds are actually utilized by firms [10].

The reform has also attempted to increase exposure to international prices, by introducing some forms of shadow prices (differentiated currency coefficients - *DVK differenzirovannye valutnye koeffitsienty*). In theory, with the use of the ex-ante coefficients the product bought or sold is no longer accounted for using the domestic wholesale price, but directly from the contractual price on the foreign market. Coefficients are differentiated according to imports and exports, geographical distribution of trade and type of product [11]. However, a number of articles have recently appeared in the Soviet press pointing out serious shortcomings in the coefficients [12]. According to many authors, coefficients do not fulfil their function of stimulating export and rationalizing imports. They do not provide the unique and stable criterion necessary to determine the macroeconomic efficiency of foreign trade and conflict with the implementation of self-financing and financial autonomy of the enterprise at domestic level. It follows that imports and exports are still mainly determined at the central level and the coefficients are adjusted in order to ensure profitability for the enterprise: they are maintained whenever this is profitable for the enterprises, and substituted with the usual instrument of price-equalization in most others.

The Soviet leadership has recently announced that a unified exchange rate will be introduced by 1991. The December 1988 Decree states, among other things, the intention to introduce a realistic exchange rate for the rouble, as well as a devaluation of 50% to be carried out in 1990. The decree is rather confused on this point, but the rationale seems to be the following. The substitution of the thousand of DVKs with a

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8. Cf. Postanovlenie (1988), art.2.

9. Cf. Postanovlenie (1988), art.14.

10. On the specific problems concerning the currency funds of enterprises, see Zverev (1987).

11. The number of coefficients is unclear, but there are certainly more than 3,000. They range from 0.2 to 6.6. Astrakhantseva-Kuznetsov (1988).

12. Cf. Antonov (1988); Doronin (1988), esp. part I; Golovaty-Antonov (1988); Shyrkalin (1988); Valyutnye (1988); Zakharov (1987).

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unified exchange rate will be achieved through the introduction of a 100% import surcharge (*nadbavka*) and export premium, which, however, will not apply to raw materials, energy, centralized supplies, nor to tourism. It is not yet clear whether the devaluation is to be applied to joint ventures [13].

The introduction of a tariff system as an indirect way of regulating imports and stimulating exports and of closing the gap between internal and foreign trade prices, is also announced in the 1988 decree, which expressly states that those measures are seen as strengthening "the basis for international commercial negotiations with the GATT and EEC" [14].

What seems to be missing in the debate among Soviet economists and policy-makers is the evolution of targets and instruments of economic policy which must parallel the decentralization process. In fact, the transition from one system to the other requires dramatic shifts in the choice of both targets and instruments of economic policy. In the classic CPE, policy intervention is essentially carried out through direct and selective controls of import and export flows, monopoly of Foreign Trade Organizations (FTO), etc. The price-equalization mechanism (import taxes and export subsidies) allows the differential domestic-foreign prices to be maintained and (theoretically) insulates the domestic economy from external fluctuations. In other words the planner, instead of promoting a microeconomic relationship between internal and external prices using one or more exchange rates, allows only a macroeconomic link, through the state budget. Thus, the exchange rate as an instrument for maintaining external balance is in many respects redundant; and this explains, at least partially, the possibility of maintaining dramatic overvaluation of the official rate in many CPEs.

When decentralization of the decision-making process takes place, the exchange rate not only regains economic significance, but becomes an essential instrument of economic policy. The coexistence of indicative and normative planning (and the increasing transformation of the first into the second) takes place during the transition period, when some objectives of economic policy (e.g. quantity of money in circulation, credit supply, etc.) can be managed almost exclusively through the use of the "new" instruments, others, like aggregate demand, may be influenced by direct and indirect ones.

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13. A detailed assessment of the effects the new measures will have on the rouble exchange rate can be found in Lavigne (1988).

14. Postanovlenie (1988), art.6.

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C. RADIKALNAYA REFORMA AND EXTERNAL CONVERTIBILITY OF THE ROUBLE.

Until now, the Soviet economy has not undertaken a complete reorganization of the system of planning, even though there are signs which indicate the willingness of the Soviet leadership to proceed in this direction.

Theoretically, a reformed planned economy is characterized by the following features [15]:

i) the dismantling of central planning: strategic decisions are still taken at the central level, but instead of administrative orders, enterprises receive only guidelines; the system of direct allocation of resources is substituted by wholesale trade between economic units;

ii) a reduction in the number of Ministries, and more generally a reorganization of the bureaucratic apparatus;

iii) the free movement of firms into different sectors, assuming that they maintain production in their original one;

iv) a reorganization of the banking system with a clear separation of the functions between central and commercial banks. The central bank has only the function of control and direction, while there is competition between commercial banks;

v) a greater availability and variety of financial assets; enterprises can re-invest part of their profits, interest-bearing and performance-linked bonds appear, as well as trading of financial assets on a secondary market;

vi) some market-based valuation of enterprises takes place.

It is clear that in this environment all obstacles to commodity convertibility are removed, and some form of external convertibility is introduced.

2. DEFINITION, ADVANTAGES AND DRAWBACKS OF CONVERTIBILITY.

a. Meaning of convertibility.

According to the definition of the International Monetary Fund, a currency is considered convertible if it meets three criteria [16]:

i) if it can be used without restrictions of a currency character for any reason whatsoever;

ii) if it can be exchanged for any other currency without restrictions of a currency character;

iii) if it can be used or exchanged at its par value, or at a rate of exchange based on the par value, or at some legal rate of exchange defined in any other way considered desirable.

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15. Cf. Nuti (1988), esp. pp. 377-384, and Nuti-Sengupta (1988).

16. Gold (1971), pp.1-2.

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In other words, under Article VIII, sections 2,3 and 4, IMF members are obliged to avoid restrictions on current international transactions, multiple currency practice and discriminatory currency arrangements. Moreover, the monetary authorities of a member country must convert balances of their currency when those balances are presented for conversion by the monetary authority of another member [17].

In reality, once the member has accepted the obligations of Article VIII, derogatory norms can be introduced and the member may impose restrictions of several kinds. It follows that various degrees of convertibility can be identified, by the effectiveness of exchange controls and restrictions, quantitative and financial barriers to external transactions, etc.

With regard to planned economies, an important distinction has been introduced in the relevant literature between commodity and financial convertibility [18].

While financial convertibility is identified with the possibility of changing a currency into any other at the exchange rate prevailing in the market, according to J. Van Brabant, commodity convertibility "means that the holder of a currency is entitled to purchase any desired goods or services at prevailing price in the currency's home market" [19].

Forms of purely financial convertibility for the socialist currencies were originally advocated by Wiles, who, given the substantial stability of the transferable rouble at the beginning of the 1970s, proposed transforming it into a reserve asset. The idea reflected at the same time the widespread feeling among Western economists that in a planned economy commodity convertibility would be more difficult to achieve than currency convertibility [20]. However, as I will try to argue below, there is not much sense in proposing forms of financial convertibility (outside capital transactions) in an economy still strictly regulated by central planning.

Soviet economists have so far proposed limited forms of convertibility, mainly on the current account. Aganbegyan speaks of internal convertibility as the "establishment of a rate for the rouble and other currencies according to which enterprises and other organizations could exchange the rouble for foreign currency, and some currency earned from the export of goods and services could be exchanged into

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17. Ibid., p.58.

18. This distinction has been discussed, sometimes with a slightly different terminology, by, among others, Altman (1960), Wiles (1973), Wilczynski (1980), Holzman (1987), Brabant (1977) and (1987).

19. Brabant (1987), pp.366-367. Obviously, the possibility to enter the local market first has to be granted to non-residents.

20. Different expressions of this limited form of convertibility have been repeatedly proposed in the literature. For instance, the possibility of establishing a convertible rouble backed by gold, a sort of premium market for gold in the form of rouble, was first proposed by Altman - Altman (1960), p. 428. More recently, Wilczynski has suggested forms of guaranteed convertibility to non-residents into gold bullion or hard currency, without free access to the Soviet market - Wilczynski (1980), p.474. Finally, a proposal has been advanced of making the rouble convertible at an exchange rate pegged to gold - The Economist November 5, 1988, pp.16-19.

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roubles" [21]. Doronin defines the rouble's internal convertibility as "a form of distributing currency resources for enterprises and organizations" [22], while Kuznetsov suggests creating an exchange market restricted to residents, along the lines of other Eastern European countries [23].

b. Advantages and drawbacks of convertibility.

The process of transition to convertibility, identified basically with overcoming goods inconvertibility and introducing a form of free exchange of foreign currencies, has its costs. First the possibility of speculation on international markets cannot be ruled out. This would be particularly disruptive for a CPE, with its scarce currency reserve and the difficulty of drawing up and administering domestic monetary and fiscal policies. The increased degree of openness exposes the domestic economy to shocks from the international market. Moreover, as is often argued in the literature [24], trade diversion effects are possible. The trade reorientation that took place at the end of the Second World War towards the Soviet Union, may be reversed once the artificial barriers against the rest of the world are removed. Furthermore, the CPEs might transfer part of their chronic excess demand to the external sector.

On the other hand, the introduction of external convertibility presents obvious advantages. First of all, the benefits of a multilateral trade regime. The substitution of multiple exchange rates with a simplified (and realistic) one gives the planner a unique macroeconomic criterion with which to judge the foreign trade performance of the economy, as well as a new, powerful instrument of economic policy. The substitution of directive and selective controls with a new tariff system (as well as the end of price equalization mechanisms) could be a first step towards participation in international organizations like GATT and IMF. At the microeconomic level, exposure to foreign competition should improve efficiency and stimulate domestic competitiveness as well.

Controversial opinions can be found in the literature about the possibility of seignorage, i.e. the advantages accruing to a country whose currency is used in international transactions. According to Holzman [25], seignorage for a convertible rouble might be negative: the currency will be used only as a store of value, thus a positive interest rate must be paid in order to convince people to hold it. However, if one considers the CMEA as a preferential trading area, the convertible rouble could be used as a mean of payment, with functions similar to those performed by the dollar during the 1960s in the West. Moreover, for seignorage to be negative the interest rate would have to be higher than the marginal cost of external finance to the USSR.

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21. Aganbegyan (1988), p.155.

22. Doronin (1988), p.38.

23. Kuznetsov (1988a).

24. Cf. for instance Csaba (1983).

25. Holzman (1987), pp.153-155.

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3. THE ROAD TO CONVERTIBILITY [26].

The aim of this section is to outline a feasible path to convertibility, both within the CMEA and with respect to Western currencies, for a CPE bearing many of the characteristics of the Soviet economy. Two separate theoretical scenarios are described, one concerning the way convertibility may be reached within the CMEA, the other the transition to a more generalized form [27]. The distinction is useful in order to outline more clearly both the advantages and drawbacks involved in the decision to move towards a more liberalized system. However, the two processes are not mutually exclusive and enlarged convertibility should not be interpreted as being strictly dependent on the attainment of regional convertibility. On the contrary, the two processes may develop in parallel, even though, as I shall try to argue below, there are necessary preconditions which need to be fulfilled in order to make the whole process feasible.

a. Convertibility within the CMEA.

i) As a first move towards liberalization some enterprises are granted the right to import and export without the preliminary authorization of the Ministry of Foreign Trade. Firms are also authorized to retain part of the earned currency to be used, within certain limits, for purchases abroad.

Three different mechanisms of currency allocation may be envisaged: i) direct allocation by the Central Bank; ii) competitive bids for currency, administered by the Central Bank itself, in which the price is determined on the basis of supply and demand; iii) a currency exchange between enterprises at contractual prices.

At this stage, both the use of national currencies and the transferable rouble are possible. In the former case firms retain foreign currency (according to technical specifications to be defined) with the possibility of using it at a later date; in the latter case the transferable rouble assumes a connotation of actually *transferable* currency, granting firms a purchasing power within the area [28].

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26. This section draws heavily on Daviddi-Espa (1989b), where many of the arguments sketched below are more fully developed.

27. The two scenarios are built on the historical experience of transition to multilateral trade and convertibility of Western European countries after the Second World War. There are obvious historical and institutional differences, which, however, do not make it unreasonable to take that process as a guideline. A more detailed analysis of the relevance of the Western European transition to convertibility for the East European CPEs is developed in Daviddi-Espa (1989a).

28. This purchasing power finds its limits in the amount of domestic goods which is available above planned quotas. In fact, as the classic system of planning still prevails, foreign customers can

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Since foreign trade is no longer strictly regulated according to ex-ante bilateral agreements and a number of enterprises operate directly on foreign markets, the possibility of disequilibrium increases [29]. The usual instruments at a planner's disposal (direct reduction of imports) can be paralleled and gradually substituted by more indirect ones (subsidies to exporting industries, taxes and incentives; tariffs and quotas) [30].

The exchange rate(s) slowly changes from being a totally passive tool, mainly used for aggregating trade flows, to a more meaningful instrument of economic policy. For this to occur, a reduction in the number of exchange rates and coefficients has to take place, or even the introduction of a unique rate, or at least of a dual rate with a distinction between planned and unplanned transactions. The prices determined by the currency bids and the exchange of surpluses between enterprises may give some indication, albeit for the moment only approximate, of a more realistic parity.

A further step is signalled by an attempt to overcome the bilateral clearing system prevailing within the CMEA [31]. A regime of effective multilateralization within the CMEA could be reached simply through the enhancement of the role of the International Bank for Economic Cooperation (IBEC) and the creation of effective mechanisms of monetary compensation. The main obstacle to the creation of a mechanism of multilateral clearing through the IBEC, is the utilization of different rates of exchange for different transactions with various countries, thus of a different value of the transferable rouble in different transactions. In reality there is not just one transferable rouble, but many (10-12). The balance has to carried out not only between countries, but hard for hard and soft for soft, and very often even according to specific commodity groups. It follows that the value of any single transaction differs even within trade flows with the same country. This also explains why the attempt in the 1970s to balance 10% of surpluses and deficits in hard currency came to nothing [32].

ii) The role of the Central Bank is redefined: the main tasks concerning daily operations in foreign currencies are decentralized to commercial banks, while the Central Bank still maintains a role of coordination and supervision of this kind of

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"mobilize" only limited amounts of goods, besides those already inserted in bilateral agreements and consequently slotted into the overall planning process.

29. In fact, even under a bilateral trade regime there may be imbalances, when plans are in physical terms and price formulas make prices move after the plan is drawn and trade agreements signed.

30. It may be supposed that the distortions introduced by these measures are less significant than those implied by the state monopoly of foreign trade, which can be interpreted as a single, gigantic non-tariff barrier. Moreover, the role played by subsidies, tariffs and quotas can be progressively reduced as the process of liberalization advances.

31. CMEA countries have made various attempts to switch to a multilateral trade regime, particularly in the 1960s. However, as conclusively demonstrated by Jozef van Brabant, "only an astonishing small amount of CMEA trade is being settled multilaterally", Brabant (1987), p. 276. For a complete exposition of the issue and relevant references, cf. Brabant (1977), esp. pp. 75-101 and Brabant (1987), esp. pp. 269-278.

32. According to Prof. Mazanov, a leading Soviet specialist on CMEA financial issues, the IBEC should be utilized more as a stabilization fund than as a clearing house.

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activity. An important instrument of indirect control by the Central Bank is the determination of the percentage of hard-currency which any enterprise manages freely.

The Central Bank must build up currency reserves, to be used in the event of the exchange rate going through temporary difficulties. In the limited context of intra-CMEA convertibility, such a problem should not be too serious for the Soviet Union. The rouble would probably be the most widely accepted mean of payments, given the predominant role of the USSR in the area.

iii) An exchange rate parity grid among the various socialist currencies may be created - a sort of Socialist Monetary System (SMS). The SMS could borrow some of the elements of the EMS:

- currency realignment as a response to pressures on the existing parities;
- the possibility for some countries of delaying their participation in the currency agreement;
- cooperation between central monetary authorities.

A limited number of commercial banks is authorized to carry out currency transactions, including arbitrage (within the narrow limits of fluctuations around fixed parities). These operations are for the moment short-term (three, six months). The main consequence is that the exchange rate is now partially independent of the supply and demand deriving simply from import and export flows.

At this stage the IBEC can play a fundamental role in relation to any unexpected disequilibrium in the balance of payments. The mechanism could be similar to those of the IMF (creation of a pool of reserve of different currencies, credit concession on main currencies only and according to conditionality criteria). Once the criteria for correcting a disequilibrium of the balance of payments have been singled out, more automatic credit concession may be envisaged.

iv) As the tendencies described above consolidate, the risks of Balance of Payments deficits increase, possible currency crises and the necessity of policy interventions arise. The quota of trade independent of planning surpasses the planned quota (with a parallel increase in the decentralization of the decision-making progress) and the number of enterprises allowed to transact with foreign partners outstrips purely domestic firms. This exposes the economy to even more pressures from the external sector, and makes the use of the "classic" instrument of macroeconomic control necessary. The exchange rate thus becomes both a possible source of disturbances and a possible instrument for their correction.

b. Convertibility with the rest of the world.

The process of commercial and monetary liberalization with the rest of the world is characterized by problems similar to those already examined in the intra-CMEA liberalization. In this case too the main issue is represented by the existence of a trade structure based on bilateral agreements, strictly regulated planning of trade flows, and currency inconvertibility.

i) In a first phase the CPE would tend to maximize the advantages derived from the prevailing bilateral agreements. Since a clearing house for clearing unbalances arising from trade flows with market economies cannot be used, it becomes essential to

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loosen the ties imposed by rigid trade and monetary controls at the firm level. More specifically, stocks of hard currencies can be allocated to firms either through a system of competitive bids, similar to those indicated above, or through direct allocation by the central monetary authorities. A system of licences in the distribution of imported goods can act as a substitute for direct allocation. On the other hand, currency management is still characterized by a strong degree of centralization and is carried out by the Central Bank, which supervises the activity of the authorized commercial banks.

ii) At a later stage, some form of external convertibility of the Soviet rouble may be declared. The opening to international quotations raises the problem of deciding which exchange rate regime should be adopted. The experience of Western European countries has shown that the creation of a monetary agreement among various states allows the determination of ratios between currencies on the basis of collective rules, rather than on the behaviour of a single country. In the case of socialist countries political, as well as economic reasons might suggest pegging in one way or another to EMS parities. The more convenient way would be pegging the convertible currency to the ECU. This would be also a way to send a "political", as well as economic, message. Such a criterion could assure stability of the exchange rate and could give indications of the variation in the degree of competitiveness towards the commercial area, which presumably will continue to be privileged.

All the above-outlined problems relating to external shocks are still present, and it becomes even more important to work out an effective mix of monetary and fiscal policy to tackle these. However, the decentralization process of the economy is already such that there is now not much difference between the kind of problems (and proposed solutions) that would characterize this environment and a market economy with a strong state sector. The Central Bank is fully responsible for exchange rate management, an essential instrument of economic policy. The accumulation of hard currency reserves is crucial to allow greater flexibility in non-residents convertibility. This may take place in the usual way: international indebtness in hard currency, trade surpluses, sale of gold stocks, and, in the event of participation in the IMF, through the allocation of SDR and other financial facilities.

A crucial role may also be played by the IBEC. Countries with a structural deficit, or in temporary difficulties, could have access to hard currency credits from the IBEC, which could manage all (or more realistically part) of the hard currency pooled together by the various socialist Central Banks (Centralized Reserve Fund) [33].

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33. The idea behind a unified management of monetary policy at CMEA level might sound utopian and premature, particularly in the light of the resistance which CMEA integration has faced in recent years. However, as recent proposals at the EEC level testify, an area seeking closer economic and monetary integration has to take into account such kind of problems. N. Thygesen - one of four outside experts of the Delors Committee of European Community Central Bankers - has recently drawn up detailed plans for setting up a European Monetary Policy Committee (EMPC), modelled on the US Federal Open Market Committee. Among other things the EMPC would manage dollar and ECU reserves pooled by national central banks. Cf. "US model for EC central bank" Financial Times, 9.1.1989.

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iii) The introduction of greater freedom in capital movement, can be considered an additional stage [34]. Theoretically, there are no more obstacles to a gradual widening of the capital market towards Western countries, depending on the success of measures which have made convertibility possible. The main problem here is deciding what kind of controls should be adopted. It may be supposed that particularly in the first phase of the liberalization process, Soviet capital moves in relevant quantities towards more profitable areas. Controls may concern both medium and long-term financial investment by Soviet residents (firms, cooperatives, etc.) and, to an even greater extent, short-term capital movements. The adoption of gradual and selective criteria would seem to be appropriate here, as the experience of many Western countries has shown.

4. PRELIMINARY CONDITIONS AND MAIN OBSTACLES TO THE INTRODUCTION OF CONVERTIBILITY.

Let us try to establish, by looking at concrete Soviet economic constraints, the main obstacles to the Soviet economy's evolution in this direction.

i) Elimination of domestic overhang.

The presence of an enormous monetary overhang in the Soviet domestic economy, as extensively argued in a recent article by V. Popov and N. Shmelev [35], originates by several factors. The state budget deficit, unofficially estimated around 11% of GNP, is now recognized as a factor, among others, dramatically fuelling the disequilibrium [36]. This overhang, as discussed below, poses serious constraints on domestic price reform, as well as on the introduction of external convertibility. Under those conditions trade liberalization would lead to a dramatic increase of imports, at *any* exchange rate.

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34. Even in the experience of Western countries, capital movements are more widely regulated than trade transactions. In the Italian experience, for instance, direct and selective controls on non-commercial transactions were only abolished at the beginning of 1988.

35. Popov-Shmelev (1988).

36. The official recognition of a budget deficit is a relatively new phenomenon for the Soviet economy. It is officially reported at 36.3 billion roubles in 1987. However, according to Soviet economists of the Institute for the United States and Canada, this figure does not take into account government borrowing from the credit system (over 60 Bn R), direct Government borrowing from the population, and budget deficits from the Republics. A recent publication by the CIA estimates the deficit for 1987 at 64.4 Bn roubles. CIA (1988), p.3.

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ii) Creation of an internal market.

The introduction of a meaningful form of external convertibility is subordinate to removing commodity inconvertibility. In other words, as is increasingly recognized by Soviet economists, a necessary precondition is the creation of a *domestic* market. For instance, in a recent article published in *Ekonomicheskaya Gazeta*, A. Tsimailo argues that the introduction of external convertibility of the rouble requires preparation of the Soviet domestic market, for integration with the world economy. There cannot be complete or even partial convertibility towards foreign currencies without real domestic convertibility of money into goods, both in the enterprise and in the consumer sector [37]. At the moment, about 95% of total import and export flows are still subject to direct control. However a gradual transition to wholesale trade in means of production is envisaged, and it is estimated that by 1990 around 50% of intermediate goods will be exchanged trough the market.

iii) Currency stabilization and establishment of a realistic exchange rate.

The third precondition is the establishment of a realistic exchange rate for the rouble. There are at least two main obstacles: the distorted structure of domestic relative prices and the gap between domestic and foreign trade prices. A domestic price reform has been announced for next year, when a new system of wholesale prices will be introduced. However, it may easily be forecasted that even after the price reform significant distortions will persist [38]. Furthermore, any proposal of price reform, especially of consumer prices, has to take the above-mentioned monetary overhang into account. The increase of prices, either once-for-all, or with gradual increases might just lead to a deterioration in the living standard of the population, without a substantial reduction of the excess demand.

It is generally recognized that at present the exchange rate of the rouble is highly overvalued, even though is rather difficult to establish the correct degree of overvaluation. However, the technical determination of a meaningful value for the exchange rate, once inflationary pressures have been weakened, should not be too complex. As already discussed, a system of state controlled auctions would be a first step, and there are indications that the Soviet Union is now moving in this direction. Other proposals include the creation of a permanent foreign exchange market, with the possibility for domestic commercial banks to carry out operations in hard currency [39].

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37. Cf. Tsimailo (1989). According to Prof. Shmelev, this kind of convertibility could be achieved in five years.

38. In particular, a recent study by Soviet economists shows that the gap between domestic and foreign prices in manufactures might even increase. Cf. Astrakhantseva-Kuznetsov (1988).

39. Cf. Kostantinov (1988). The proposal to build an internal market for foreign currency has also been put forward by Soviet officials. Cf. God samostoyatel'noi (1988).

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iv) Accumulation of currency reserves.

Gold sales already represent a significant source of hard currency revenues (estimated at about 15% of total hard currency revenues, i.e. $ 3.5 bn in 1987). The USSR possesses large stocks and would presumably be able to slightly increase gold sales without a dramatic drop in prices.

In parallel the hard currency debt can be utilized as a source of gross accumulation. The Soviet Union has a good credit reputation with Western bankers and has in the past been able in the past to obtain favourable conditions.

Finally, should the USSR join the IMF, other funds may be made available from the usual financing mechanisms of this organization.

v) Creation of a stock of goods potentially exportable to the world market.

Up to now the Soviet Union has been unable to expand its manufactured product export towards Western industrialized countries. The well know problems of quality, reliability and servicing of Soviet production have been the main cause, although the trade restrictions and quotas imposed by many countries, above all those of the European Community have also played a role. Here, more than in any other sector of the Soviet economy, there is ample room for manouvre, in particular if the USSR manages to take advantage of collaboration with Western partners (joint ventures, free trade zones, etc.). However, it should be taken into account that, as Nuti and Sengupta have pointed out, "the export performance of a CPE is a question of restricting absorption to make room for export, and not simply a question of "competitiveness" of a kind that may be redressed with devaluation" [40]. In a typical CPE environment devaluation will not work; it will merely be inflationary.

5. INTRA-CMEA CONVERTIBILITY VERSUS CONVERTIBILITY AT LARGE: A PRELIMINARY ASSESSMENT.

We have seen that convertibility is a proclaimed aim of economic policy, but, as yet, Soviet long-term strategy remains unclear. On the one hand official statements seem to indicate a possible two-stage approach: first regional and then worldwide convertibility; on the other Soviet specialists tend to emphasise the obstacles to such a policy and judge more favourably the introduction of an enlarged form of convertibility.

In his speech at the 43rd Session of CMEA, Prime Minister N. Ryzhkov noted: "As a promising goal we should have in mind the gradual transfer, as the necessary conditions arise, from the mutual convertibility of national currencies to the creation of a collective (i.e. CMEA - RD) monetary unit, which would be convertible in the future

[40]. Cf. Nuti-Sengupta (1988), p.35.

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into freely convertible currencies as well" [41]. Similar positions were confirmed by Ryzhkov himself at the following session of the CMEA, last summer [42]. A. Aganbegyan clarifies the reason why such an approach is preferable. "Firstly, it will be possible to establish a convertible rouble in relation to the currencies of the socialist countries, made easier by their similar types of economies and the existing processes of economic integration" [43]. More recently, similar arguments have also been advanced by K. Mikul'skii, who also advocates broader utilization of national currencies of CMEA countries, especially in direct links between enterprises, and the creation of a CMEA currency stock exchange, where such currencies can be exchanged [44].

On the other hand, many Soviet specialists seem to consider the attainment of convertibility within the CMEA a more difficult task than convertibility towards Western currencies [45]. The main argument is that within CMEA the structure of prices is distorted to a different extent in different countries, and only after a harmonization of price structure will it be possible to consider such an hypothesis. They point to further difficulties in the lack of hard-currency reserves, in the divergent economic policies pursued by the various countries, and in the problem of commodity inconvertibility at domestic level.

However, even if many of the difficulties facing the Eastern European economies stem from the closed nature of the socialist "market", a process of polarization is undoubtedly taking place in international trade. In this respect, it is not clear why socialist countries should give up the opportunities derived from being part of a commercially (and in some respect politically) integrated area, particularly when many of them are attempting dramatic modifications of the system of planning and management. The CMEA, once tasks and lines of development have been redefined, may play a very important role in the process of opening up to the rest of the world, and may help to minimize the risks involved in such a profound process of transformation. It is equally clear, on the other hand, that the introduction of multilateralism and convertibility inside the CMEA and a far-reaching decentralization of the domestic economies, will not be enough. The process of transition to convertibility within the area must be accompanied by a equally gradual process of "opening up" to the rest of the world, and in particular to Western industrialized countries.

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41. BBC Summary of World Broadcast EE/8699, 15.10.1987.

42. Cf. Pravda, 6 July 1988, p.1.

43. Aganbegyan (1988), p.155.

44. Cf. Mikul'skii (1989).

45. Many Soviet economists have pointed out the same kind of difficulties in private interviews.

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6. CONCLUSIONS.

In the previous pages I have tried to outline a possible way in which a CPE, and more specifically the Soviet Union, may arrive at meaningful external convertibility of its domestic currency, and to point out the main obstacles to this process. It must be stressed once again, that the plausibility of the transition towards convertibility outlined above depends on four basic assumptions: the positive development of the domestic reform process; the gradual nature of the process of liberalization of commercial and financial operations; the possibility of slowing down the liberalization process itself, resorting to short-term forms of trade discrimination, without the risk of trade retaliation; and, finally, a cooperative attitude by Western countries, which may help to ease the transition process.

If these conditions are met, and I have tried to argue that they can be, the attainment of meaningful external convertibility of the Soviet rouble may well be feasible, although progress towards this goal will be slow and gradual.

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